IN THE

UNITED STATES CIRCUIT COURT OF APPEALS

FOR THE NINTH CIRCUIT. 3

No. 6459.

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*,

vs.

MURPHY OIL COMPANY, a Corporation, *Respondent*.

APPEAL FROM THE BOARD OF TAX APPEALS.

BRIEF AMICUS CURIAE.

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TABLE OF CONTENTS.

	Page
PRELIMINARY STATEMENT	1
I. A BONUS RECEIVED ON AN OIL LEASE CONSTITUTES A RETURN OF CAPITAL, AT LEAST TO THE EXTENT OF THE CAPITAL REMAINING TO BE RECOVERED THROUGH DEPLETION BY THE TAXPAYER AT THE DATE OF THE LEASE	2
II. AN OIL LEASE BONUS CONSTITUTES AN ADVANCE PAYMENT OF ROYALTIES AND AS SUCH IS SUBJECT TO DEPLETION, AT LEAST IN THE SAME MANNER AND TO THE SAME EXTENT AS OTHER ROYALTIES	7
CONCLUSION	16

Table of Cases.

Court Cases.

Brewster v. Gage, 280 U. S. 327, at 336 5
Burnet v. Thompson Oil and Gas Co., 238 U. S. 301 .... 5, 6
Commissioner v. Stephens-Adamson Mfg. Co., decided July 27, 1931, by the U. S. Circuit Court of Appeals for the Seventh Circuit 14
Farmers Loan & Trust Co. v. State of Minnesota, 280 U. S. 204, 74 L. Ed. 371 14
Fawcus Machine Co. v. U. S., 282 U. S. 375 .... 5, 6
National Lead Co. v. U. S., 252 U. S. 140 5
New York, New Haven R. R. v. Interstate Commerce Commission, 200 U. S. 361 5
Poe v. Seaborn, 282 U. S. 101 .... 5, 6
Tyler v. U. S., 281 U. S. 497 14
U. S. v. Biwabik Mining Co., 247 U. S. 116 .... 8, 15

Page

Von Baumbach v. Sargent Land Co., 242 U. S. 503.. 15
Waller v. Commissioner of Internal Revenue, 40 F. (2d) 892 13
Work v. U. S. Ex Rel William T. Mosier, et al, 261 U. S. 352 8

United States Board of Tax Appeals Cases.

Appeal of Clearfield Lumber Co., 3 B. T. A. 1282... 9, 15
Inspiration Consolidated Copper Co. v. Commissioner, 11 B. T. A. 1425 .... 9, 11
National Oil & Gas Co. v. Commr., 6 B. T. A. 399.. 9, 11
Appeal of Nelson Land and Oil Co., 3 B. T. A. 315.. 8, 15
Appeal of R. M. Waggoner, 5 B. T. A. 1191.... 9, 10, 11
Waller v. Commr., 16 B. T. A. 574.......... 12

Statutes.

Article 215(a) of Reg. 45, 62, 65 .... 3, 4
Article 215(b) of Reg. 45 10
Sec. 234(a)(9) Revenue Act of 1918 2
S. M. 3399, C. B. IV-1, p. 167 3
Treasury Decision 3938, V-2, C. B. p. 117.......... 4

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PRELIMINARY STATEMENT.

The question involved in the instant case is whether a bonus received by the taxpayer for an oil lease was subject to depletion, or, stated in another way, whether its receipt resulted in the exhaustion of at least a part of the depletable base.

The Maricopa Investment Company, a California corporation, has the same question involved in a case now

pending before the United States Board of Tax Appeals entitled *The Maricopa Investment Company v. Commissioner of Internal Revenue,* Docket No. 32689.

The facts in said case, Docket No. 32689, are, briefly, as follows:

In the year 1920 the Maricopa Investment Company leased 480 acres of land to the Standard Oil Company of California by which it received a so-called bonus of $200,000 in cash, with an agreement on the part of the lessee to deliver to said lessor one-sixth of all the oil produced upon said property. The fair market value of said property as of March 1, 1913, was in excess of $200,000. In the instant case the Board refused to allow a deduction for depletion against a similar bonus.

As the question in the two cases seems to be identical, the undersigned, as counsel for said Maricopa Investment Company (having first obtained the Court's permission), respectfully files this brief in support of the proposition that a bonus on a lease constitutes an advance royalty, and is, therefore, subject to depletion in the manner provided for in the Commissioner's Regulations.

I. A Bonus Received on an Oil Lease Constitutes a Return of Capital, at Least to the Extent of the Capital Remaining to be Recovered Through Depletion by the Taxpayer at the Date of the Lease.

Section 234(a)(9) of the Revenue Act of 1918 provides as follows:

> "Sec. 234 (a) That in computing the net income of a corporation, subject to the tax imposed by section 230 there shall be allowed as deductions:
>
> * * * * * * * * *
>
> "(9) In the case of mines, oil and gas wells, other natural deposits, and timber, *a reasonable allowance for depletion* and for depreciation of improvements, *according to the peculiar conditions in each case,* based upon cost including cost of development not otherwise deducted: *Provided,* That in the case of

such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: *Provided further,* that in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within thirty days thereafter; *such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary.* In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee." (Italics ours)

Article 215 (a) of Regulations 45, 62, and 65 promulgated under the Revenue Acts of 1918, 1919, 1921, and 1924, respectively, provides as follows:

"Art. 215. Depletion-Adjustments of accounts based on bonus or advanced royalty.—(a) *Where a lessor receives a bonus or other sum in addition to royalties, such bonus or other sum shall be regarded as a return of capital to the lessor, but only to the extent of the capital remaining to be recovered through depletion by the lessor at the date of lease.* If the bonus exceeds the capital remaining to be recovered, the excess and all the royalties thereafter received will be income and not depletable. If the bonus is less than the capital remaining to be recovered by the lessor through depletion, the difference may be recovered through depletion deductions based on the royalties thereafter received. The bonus or other sum paid by the lessee for a lease made on or after March 1, 1913, will be his value for depletion as of date of acquisition." (Italics ours)

This Article was construed by the Solicitor for the Commissioner of Internal Revenue in S. M. 3399, C. B. IV-1, p. 167, as follows:

> "The 'bonus or other sums in addition to royalties' mentioned in the above-quoted article is considered to be the price paid for the right to explore for and extract oil or mineral. While it is not strictly a sale of that right, it is analogous to a sale and is usually treated as such by the parties. Accordingly, it is held that such 'bonus or other sum' is a return of capital based on the cost or March 1, 1913, value of the property as a mineral or oil property * * *."

Article 215 was amended by Treasury Decision 3938, V-2, C. B., p. 117, which allowed as a deduction for depletion in respect of a bonus,

> "* * * an amount equal to that proportion of the cost or value of the property on the basic date which the amount of the bonus bears to the sum of the bonus and royalties expected to be received."

From January 2, 1921, until 1926, however, Article 215, as quoted above, remained in full force and effect. Many transactions were undoubtedly entered into, and many returns were filed in reliance upon Article 215 as contained in Regulations 45, 62, and 65. The return of the Maricopa Investment Company was so filed, and, insofar as it excluded the entire bonus received from net income, was accepted as correct by the Commissioner until Article 215 was amended in 1926. Until the amendment to Article 215 was published in the latter part of 1926, it never occurred to the Maricopa Investment Company that it would ever be required to pay a tax on any part of the bonus, as the amount thereof was exceeded by the March 1, 1913, value of the property. So far as this company was concerned, therefore, the Commissioner's amendment in 1926, to say nothing of the Board's decision in the instant case nullifying the amendment as well as the original Regulation, suddenly imposed a tax on that which for five years the Commissioner had said was a return of capital.

It is significant to note that after Article 215 of Regula-

tions 45 was promulgated under the Revenue Act of 1918, Congress re-enacted without material change the depletion provisions of that Act in the Revenue Acts of 1921, 1924, and 1926. These Acts became effective on November 23, 1921, June 2, 1924, and February 26, 1926, respectively. We submit Congress must have had knowledge of the Commissioner's Regulation and, therefore, tacitly approved Article 215 as originally promulgated.

> *National Lead Co. v. U. S.*, 252 U. S. 140, at 146-147
> *New York, New Haven R. R. v. Interstate Commerce Commission*, 200 U. S. 361, at 401-402.

In any event, such administrative interpretation is entitled to great weight.

> *Brewster v. Gage*, 280 U. S. 327, at 336
> *Fawcus Machine Co. v. U. S.*, 282 U. S. 375, at 379
> *Poe v. Seaborn*, 282 U. S. 101, at 116
> *Burnet v. Thompson Oil and Gas Co.*, 283 U. S. 301.

The attitude of the Supreme Court on this question is clearly shown in the following quotations from the cases cited above:

Brewster v. Gage, 280 U. S. 327, at 336:

> "These regulations were prepared by the department charged with the duty of enforcing the acts. The rule so established is reasonable and does no violence to the letter or spirit of the provisions construed. *A reversal of that construction would be likely to produce inconvenience and result in inequality. It is the settled rule that the practical interpretation of an ambiguous or doubtful statute that has been acted upon by officials charged with its administration will not be disturbed except for weighty reasons.* Logan v. Davis, 233 U. S. 613, 627, 58 L. ed. 1121, 1128, 34 Sup. Ct. Rep. 685; Maryland Casualty Co. v. United States, 251 U. S. 342, 349, 64 L. ed. 297, 302, 40 Sup. Ct. Rep. 155; Swendig v. Washington

Water Power Co., 265 U. S. 322, 68 L. ed. 1036, 1040, 44 Sup. Ct. Rep. 496." (Italics ours.)

Poe v. Seaborn, 282 U. S. 101, at 116:

> "On the whole, we feel that, were the matter less clear than we think it is, on the words of the income tax law as applied to the situation in Washington, we should be constrained to follow the long and unbroken line of executive construction, applicable to words which Congress repeatedly reemployed in acts passed subsequent to such construction (New York v. Illinois, 278 U. S. 367, 73 L. ed. 426, 49 S. Ct. 163; National Lead Co. v. United States, 252 U. S. 140, 64 L. ed. 496, 40 S. Ct. 237; United States v. Farrar, 281 U. S. 624, 74 L. ed. 1078, 68 A. L. R. 892, 50 S. Ct. 425)."

Fawcus Machine Co. v. United States, 282 U. S. 375, at 379:

> "*The regulations were made pursuant to express authority* (see sec. 1309 of the Revenue Act of 1918). *They are valid unless unreasonable or inconsistent with the statute.* United States v. Grimaud, 220 U. S. 506, 517, 518, 55 L. ed. 563, 567, 568, 31 S. Ct. 480; International R. Co. v. Davidson, 257 U. S. 506, 514, 66 L. ed. 341, 326, 42 S. Ct. 170. They constitute contemporaneous construction by those charged with the administration of the act, are for that reason entitled to respectful consideration, and will not be overruled except for weighty reasons." (Italics ours)

This would seem to be particularly true, where as in the instant case the statute provides for a "reasonable allowance for depletion * * * according to the peculiar conditions in each case," and also provides that such "reasonable allowance" shall be "made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary." As Mr. Justice Stone said in the case of *Burnet v. Thompson Oil & Gas Co.,* cited above,

> "It is clear that Congress intended that the lessee of an oil well should be entitled to a reasonable allowance for depletion based upon cost or March 1, 1913, value. It did not however attempt to prescribe a formula for ascertaining it, but expressly delegated that function to the Commissioner of Internal Revenue who was to make rules and regulations to that end."

In promulgating Article 215, the Commissioner realized that as a rule the production of either minerals or oil is a hazardous enterprise. In view of that fact he ruled that a lessor who gives a lease for a large bonus and a comparatively small annual royalty should be entitled to deplete his cost or March 1, 1913, value against the cash received to the full extent of said cash and to deplete the balance of his base against the subsequent annual royalties which might or might not produce a substantial amount of revenue. In other words, it was a practical regulation which assured a lessor the return of his capital at least to the extent of the cash bonus received, regardless of the hazardous nature of the enterprise or uncertainty of receiving subsequent payments by way of annual royalties.

We respectfully submit, therefore, that the rule announced in Regulations 45, and repeated in Regulations 62 and 65, should not be disturbed, and, in accordance with said rule oil lease bonuses should be treated as a return of capital to the extent of the cost or March 1, 1913, value, whichever is applicable.

II. An Oil Lease Bonus Constitutes an Advance Payment of Royalties and as Such is Subject to Depletion, at Least in the Same Manner and to the Same Extent as Other Royalties.

It has been squarely held by the United States Supreme Court that a so-called bonus on a lease constitutes an advance royalty.

U. S. v. Biwabik Mining Co., 247 U. S. 116
Work v. United States Ex Rel William T. Mosier et al, 261 U. S. 352.

In the *Work* case Mr. Chief Justice Taft, in delivering the opinion of the Court, said in part as follows:

> "The bonus, which was the result of bidding for desirable and profitable oil and gas leases, secured for the members of the Osage Tribe the just value of the use of their property which the fixing of royalties in advance by the President was not adapted to give them. It was, in effect, a supplement to the royalties already determined. It was really part of the royalty or rental in a lump sum or down payment. We do not see how it can be classified as anything else. It was income from the use of the mineral resources of the land. *Of course, it involved a consumption and reduction of the mineral value of the land, but so does a royalty. This is an inevitable characteristic of income from the product of the mine.*" (Italics ours)

This principle was recognized by the Board in the case at bar, and also in *Appeal of Nelson Land and Oil Company*, 3 B. T. A. 315, relied upon by the Board in its opinion in the instant case. In fact in the *Nelson* case the Board stated:

> "The method prescribed by the statute of returning to a corporate taxpayer its capital investment, free from taxation, is through the depletion allowance provided for by section 234(a)(9) of the Revenue Acts of 1918 and 1921. A bonus paid under such circumstances is as much a part of the consideration as the royalties. *It is in fact and in substance a part of the royalties.*" (Italics ours)

In the *Nelson Land and Oil Company* case, however, no claim for depletion based upon either cost, March 1, 1913, value or discovery value was made. The factors necessary to determine a depletion rate were not proved.

The Board rested its decision in the instant case upon the following theory:

> "While expected production undoubtedly was considered in fixing the amount of the bonus, it is elementary under the laws governing such agreements that its payment did not, in anywise, depend upon, or relate to, production. The lessee's liability therefor was fixed by the terms of the contract. On the other hand, *the operation of the principle of depletion depends upon exhaustion of resources through production* * * *." (Italics ours)

The theory announced in the instant case is in direct conflict with other decisions of the Board.

> *Appeal of Clearfield Lumber Co.,* 3 B. T. A. 1282
> *Appeal of R. M. Waggoner,* 5 B. T. A. 1191
> *National Oil & Gas Co. v. Commr.,* 6 B. T. A. 399
> *Inspiration Consolidated Copper Co. v. Commr.,* 11 B. T. A. 1425.

The Board in the instant case made no attempt to distinguish those cases although the decisions therein had been rendered prior to the decision in this case.

In the *R. M. Waggoner case, supra,* the taxpayer claimed depletion on the basis of production for the taxable year in question. The Commissioner had computed the allowable depletion on the basis of receipts from sales. In sustaining the Commissioner the Board said, *inter alia:*

> "The purpose of the depletion provision of the statute is to return to the taxpayers having an interest in oil properties through the aggregate of annual depletion allowances, the basis of the depletion allowances, that is, the cost or the value on March 1, 1913, or the value of the oil in place at date of discovery or within thirty days thereafter, before any income therefrom during the year shall be subjected to tax. These taxpayers employed the cash receipts and dis-

bursements method of accounting, and in view of this and other facts disclosed by the record, *we are of the opinion that the reasonable allowance to which these taxpayers were entitled for the year 1919 should be computed upon the basis of the royalty income received within the year.* It is only in this manner that taxpayers employing the cash receipts and disbursements method of reporting income can get the full benefit of the provision of section 214(a)(10) for, if a taxpayer employing such a method of accounting should for any reason receive no royalties from such source and had no other income from which to take the deduction of the allowance for depletion, he would receive no benefit from the statute; and if he should receive in a subsequent year his royalties, as the facts show was true in the case of these taxpayers, he would be required to pay a tax upon the entire amount thereof. *The tax is an annual tax and the deductions are annual deductions and it is the intent and purpose of the statute that income and deductions shall be treated consistently.*" (Italics ours)

It is also interesting to note that in support of its principle in the *Waggoner* case, the Board cited Article 215(b) of Regulations 45, which provides in part as follows:

"* * * Where the owner has leased a mineral property for a term of years with a requirement in the lease that the lessee shall extract and pay for, annually, a specified number of tons, or other agreed units of measurement, of such mineral, or shall pay annually, a specified sum of money which shall be applied in payment of the purchase price or royalty per unit of such mineral whenever the same shall thereafter be extracted and removed from the leased premises, *the value in the ground to the lessor, for purposes of depletion, of the number of units so paid for in advance of extraction will constitute an allowable deduction from the gross income of the year in which such payment or payments shall be made,* * * *." (Italics ours)

After citing this Regulation of the Commissioner's, which provides for depletion against advance minimum royalties, the Board goes on to say in the *Waggoner* case:

> "The Commissioner has held that a lessor of mining property who waived his rights to royalties for several years and received all of the royalties in 1917 was entitled, since he submitted his returns for those years on the cash receipts and disbursements basis, to deduct from income received in 1917 such depletion allowance as appertained to that income. See A. R. M. 17, C. B. No. 2, p. 144. We think this holding applied the correct principle and followed the intendment of the statute. *All that the statute provides is that in computing net income there shall be allowed as a deduction a reasonable allowance for depletion 'according to the peculiar conditions in each case,' and this reasonable allowance must be determined in the light of the provisions of sections 212 and 213 of the Act defining gross and net income.*" (Italics ours)

In the case of *National Oil & Gas Co. v. Commr.*, 6 B. T. A. 399, the Board in following its opinion in the *Waggoner* case, said:

> "In the *Appeal of R. M. Waggoner*, 5 B. T. A. 1191, it was held that, in such circumstances as we have here, allowance for depletion could be taken only upon the basis of the oil sold during the year, the proceeds of which were included as income; *in other words, the depletion was to be taken upon the same basis as the income was returned.* The decision in that appeal is decisive of the question here involved." (Italics ours)

In the *Inspiration Consolidated Copper Co.* case, *supra*, the Board applied the same principle to a taxpayer on the accrual basis.

These cases are irreconciliable with the decision in the instant case. In the instant case the Board says depletion

must be taken as production occurs. In the cases cited above it refused to apply that theory.

In this connection it is interesting to consider the Board's decision in *Waller v. Commr.,* 16 B. T. A. 574. In that case a partnership, of which the taxpayer was a member, acquired from the owners in 1919 a number of oil and gas leases on unproven territory, including the quarter section of land involved in that case. In March, 1921, oil was discovered on 40 acres of the quarter section in question, and within 30 days thereafter the partnership entered into a contract with the Gilliland Oil Company by which the partnership did "sell, assign, set over, transfer and deliver" unto said Company an undivided one-half interest in the lease for the consideraton of $600,000, which was immediately paid in cash. In April, 1921, oil was also discovered on the remaining 120 acres, and within 30 days thereafter an instrument similar in terms was executed conveying the whole interest of the partnership to the Ohio Oil Co. The consideration for the conveyance was $3,000,000 in cash; $1,000,000 out of the first oil produced, which was paid, and a one-eighth royalty. The Board's entire opinion is devoted to the question whether these instruments were assignments or sub-leases, *apparently upon the theory as conceded by the parties that if they were sub-leases the taxpayers as sub-lessors were entitled to depletion, but if they were assignments the taxpayers as assignors were not entitled to depletion.* In conclusion the Board in its opinion in the *Waller* case says:

> "Our conclusion is that the contracts between Smitherman and the Gilliland Oil Co. and the Ohio Oil Co. were not subleases, but they were assignments. *Accordingly, petitioners are not entitled to depletion based on discovery value as deductions from the consideration received for such assignments.*" (Italics ours)

No reference is made by the Board in the *Waller* case to its prior decision in the instant case. It could have disposed of the *Waller* case on the ground relied upon in the instant case. In this connection it is also interesting to note that in the instant case four of the Board members dissented.

The *Waller* case was appealed by the taxpayer to the United States Circuit Court of Appeals for the Fifth Circuit. The Court in affirming the Board said: *Waller v. Commissioner of Internal Revenue,* 40 F. (2d) 892

> "This is a petition to review a decision of the Board of Tax Appeals which rejected the claim of petitioners that they were entitled, under section 214 (a) (10) of the Revenue Act of 1921, 42 Stat. 241, to deductions from their net incomes for the years 1921 and 1922 for depletion of certain oil and gas leases based on discovery value, and which held them liable for deficiencies upon their net incomes for those years without making allowances for such depletion.
>
> * * * * * * * * *
>
> "If these instruments constitute assignments or sales as distinguished from subleases, petitioners concede that the decision of the Board was correct; *on the other hand, if they were subleases, the decision was wrong.*"

In the instant case it is not disputed that the instrument in question was a lease which *a fortiori* would entitle the lessor to the same rights as the sublessor. Based upon the Court's opinion in the *Waller* case, therefore, "the decision was wrong" in the instant case.

We submit the theory which treats income and the deduction for depletion consistently is much more equitable and practicable than the theory which treats the deduction independently of the income from the property. Suppose for example a taxpayer exhausts his entire mine or well within one taxable year and holds the entire production for sale in a subsequent year. Suppose also he has no

income from any other source. If depletion can be taken only as production occurs, he would get his deduction in a year when he has no income, and get his income in a year when he is allowed no deduction. Take for example another case. Suppose a lessor and lessee estimate the total possible production and provide for a down payment upon the execution of the lease of the then equivalent of the total expected royalties. Suppose also that the entire production occurs in the following year. Again the lessor receives his income in a year when he is allowed no deduction and is allowed a deduction in a subsequent year when he has no income. Is it conceivable that Congress contemplated such an impractical result? We say no, in view of the statement by the Supreme Court in *Farmers Loan and Trust Co. v. State of Minnesota,* 280 U. S. 204, 74 L. ed. 371, that

> "*Taxation is an intensely practical matter, and laws in respect of it should be construed and applied with a view of avoiding, so far as possible, unjust and oppressive consequences.*" (Italics ours)

And, again, in *Tyler v. U. S.,* 281 U. S. 497,

> "*Taxation,* as it many times has been said, *is eminently practical.*" (Italics ours)

Similarly, in *Commissioner v. Stephens-Adamson Mfg. Co.,* decided July 27, 1931, the United States Circuit Court of Appeals for the Seventh Circuit said:

> "Congress in enacting this legislation was dealing with a most practical problem—the problem of taxation. *Tyler v. U. S.,* 281 U. S. 497, 50 S. Ct. 356, 74 L. ed. 991. *In construing any Revenue Act, we, therefore, should not ignore the ordinary every-day commercial experiences which constitute its background.*" (Italics ours)

The Board's decision in the instant case, we submit, ignores "ordinary every-day commercial experiences."

It will no doubt be suggested that the question has already been passed upon by the Supreme Court in *U. S. v. Biwabik Mining Co.*, 247 U. S. 116. The Board relied upon the *Biwabik* case in the *Nelson Oil and Land Co.* case, *supra,* and cited the latter case with approval in its decision in the instant case. It is true that the Supreme Court refused to allow depletion against a bonus in the *Biwabik* case. That case, however, involved a claim under the Corporation Excise Tax Act of 1909, which contained no provision for depletion. That the Court's decision undoubtedly would have been the other way had the Act contained a provision for depletion is clearly indicated by the following quotation from the Court's decision in *Von Baumbach v. Sargent Land Company,* 242 U. S. 503, relied upon as authority in the *Biwabik* case:

> "It may be admitted that a fair argument arises from equitable considerations that, owing to the nature of mining property, an allowance in assessing taxes upon income should be made for the removal of the ore deposits from time to time. Congress recognized this fact in passing the income tax section of the Tariff Act of 1913 (Sec. II, 38 Stat. at L. 166, 167, chap. 16, Comp. Stat. 1913, Secs. 6319-6322), when it permitted 'a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business, not to exceed, in the case of mines, 5 per centum of the gross value at the mine of the output for the year for which the computation is made;' and in the Income Tax Law of September 8, 1916 (1915-1916 Stat. 756, 769), a reasonable allowance is made in the cases of mines for *depletion* thereof, 'not to exceed the market value in the mine of the product thereof which has been mined and sold during the year for which the return and computations are made.' *These provisions were not in the Act of 1909,* and, as we have said, we think that Congress, in that Act, used the

term 'depreciation' in its ordinary and usual significance.'' (Italics ours)

In view of the foregoing, we respectfully submit that under the Revenue Acts beginning with the Act of 1913, a taxpayer receiving a bonus on an oil lease is entitled to a deduction for depletion against that bonus.

CONCLUSION.

In conclusion we respectfully submit that a bonus on an oil lease is an advance royalty, and, as such, is, under the Revenue Acts, subject to a deduction for depletion; that the Commissioner's original regulations, having been tacitly approved by Congress in subsequently re-enacting similar statutory provisions, must be held to be reasonable and should be applied to each taxable year for which a return was filed prior to the amendment contained in Treasury Decision 3938; that in any event, since taxation is ''an intensely practical matter,'' the depletion deduction must be allowed against the income from the property, and can not be based solely upon production independently of income; and that income represented by bonus on an oil lease should stand its proportionate share of the total depletion allowable on the particular property.

Respectfully,

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